Relations of Reserve Banks to Member Banks and Inter-Relations of Federal Reserve Banks

By R. M. GIDNEY
Controller at Large, Federal Reserve Bank of New York

THE outstanding characteristic of the American banking system—a tremendous number of practically independent banks, great and small—does not make for concerted, uniform or effective action in dealing with banking, credit and currency problems on a nation-wide scale and in a broad way. The need for means whereby these numerous independent banks could coöperate for mutual protection and for greater service to the commerce, industry and agriculture of the country, has long been recognized by students of American banking organization and methods.

The solution suggested by the experience of other countries which have highly developed systems of branch banking supported by great central banks, has never seemed acceptable to the American public. The form of organization adopted to supply the elements formerly lacking in American banking, was necessarily designed to do so without diminishing or impairing the independence of the existing banking institutions. The Federal Reserve System was created to enable member banks, while operating independently as before, to mobilize or unite their reserve funds and make them more available to meet demands for increased credit accommodation or gold withdrawals for domestic purposes or export. The Federal Reserve Banks were to be supplementary to an already existing system consisting of some 7,500 national banks and over 19,000 state institutions, a very considerable proportion of these institutions being expected to take membership and thus give to the system the support necessary to make it a going concern, capable of affording to its members the facilities and advantages which it was expected to create. The provision for compulsory membership of over 7,500 national banks then in existence give assurance of ample support at the outset.

The purpose, then, of the Federal Reserve System was to make possible the association of the banks of the country in order to supply the elements of mutual protection, service and facilities which our system of independent banks had lacked, and, in its essential features, it may briefly and accurately be described as a great coöperative banking association. It includes at this time about 8,200 national banks, and 1,625 state banks and trust companies. The latter have become members voluntarily under the permissive provision of the Federal Reserve Act.

RESERVE BANKS ARE PRIVATE CORPORATIONS

The circumstances attending the creation of the Federal Reserve System and the distinctly governmental character of the procedure which brought it into existence, have tended to create the impression that the Federal Reserve System is a purely governmental agency, an impression strengthened by the highly important work done by the Federal Reserve Banks acting as fiscal agents of the government in selling and handling government securities during

and since the War. The fact is, however, that the twelve Federal Reserve Banks are private corporations organized under an Act of Congress, their only stockholders being the member banks whose stock subscription is proportionate to their capital and surplus. Their operations are directed by twelve boards of directors. Two-thirds of the members of each board are elected by the member banks, and one-third are appointed by the Federal Reserve Board. Each Federal Reserve Bank is thus operated under the control of a board of directors including three government representatives, most of whom are business men, three bankers and three men engaged in commerce, industry or agriculture, but not connected as officer or director with any bank. The directorates of the Federal Reserve Banks include not only bankers, but also men experienced and successful in various lines of business, industry or agriculture. This feature of the relationship between the Federal Reserve Banks and their members is worthy of emphasis. It should be understood that the member banks, through their right to two-thirds of the directors of the Federal Reserve Banks, are in control of the actual operations of the Federal Reserve Banks, subject to supervision by the Federal Reserve Board.

Relations between Federal Reserve Banks and their members have grown to be very much like relations between the larger banks of the country and their out-of-town correspondents. The member bank stockholders of the Federal Reserve Banks use these Banks as depositaries for their legal reserves in amounts determined by law, thus bringing about the mobilization of banking reserves contemplated by the Federal Reserve Act, and furnishing the Federal Reserve Banks with the funds which are the basis for their operations. These relations constitute the minimum which may exist between the Federal Reserve Banks and their members. For some time after the organization of the Federal Reserve Banks, a very large proportion of the member banks did not transact any business through them, and relations were only of the bare minimum above described.

The relationship now existing between the Federal Reserve Banks and their members is the result of evolution and is far closer than in the earlier days of the System. The attitude of the national bank officers whose institutions were practically drafted into the Federal Reserve System at the time of its establishment, was then not altogether friendly, and many of them were strongly antagonistic to the new System and openly expressed their intention to have as little to do with it as possible. These bankers had a natural reluctance to break or impair long established ties, and felt that the Reserve Banks would be in a sense government bureaus and would adopt methods involving red tape and affording little opportunity for close and sympathetic personal relations. Many believed that member banks, especially those in the smaller places, would have little paper of a character eligible for rediscount, and that as they would be obliged to continue to carry reserves with their correspondents, membership in the System would be more of a burden than a privilege.

Those entrusted with the management of the Federal Reserve System, appreciating and understanding the attitude of the member banks, realized that upon them devolved the duty of so conducting the Federal Reserve Banks as to disarm criticism and to make the service of the Reserve Banks to their members so satisfactory and convenient that those who had antici-

pated unpleasant relations would be obliged to revise their opinions. Notwithstanding this forward-looking attitude on the part of the managers of the Federal Reserve System, progress toward closer relations with member banks was slow, and did not become really appreciable until the pressure of problems connected with war financing in 1917 brought about a fuller utilization by member banks of the facilities of the Federal Reserve System and consequently a better understanding of its possibilities for service.

WAR LOANS A CEMENTING FACTOR

To the Federal Reserve Banks was given the great task of organizing in their respective districts distributing agencies for the huge loans which the government found it necessary to float and for this undertaking the aid and support of bankers, both member and non-member, was sought and obtained. The splendid efforts of those associated in this work may be inferred from results. The close relationship thus developed and the splendid coöperation of the bankers with the Federal Reserve Banks in placing the government's loans, made for understanding and mutual appreciation between the Reserve Banks and their members to such an extent that long before the work of government financing had ceased to require the most active efforts of those engaged in it, the attitude of the member banks had changed from passive toleration or outspoken antagonism, to an attitude on the part of the majority of the member banks distinctly friendly to the Federal Reserve System.

With war-time activity, came demand for credit expansion which brought into play the loaning function of the Federal Reserve Banks. Member banks which had been skeptical of the value of the Federal Reserve System and had doubted the necessity for its existence, found themselves obliged to borrow if they were to do their part in war finance, and for the first time a convincing illustration of the value of the loaning activities of the Reserve Banks was given. Member banks soon found that borrowing at Reserve Banks did not involve unnecessary formality or red tape, as the loan policies of the Reserve Banks have in general been along very liberal lines. Loan applications have uniformly been acted upon promptly on day of receipt, so that a member bank sending in paper for rediscount can count upon receiving credit for the proceeds thereof as promptly as if it were a remittance of bank drafts. Promptness, liberality of treatment and willingness to meet all proper demands, which characterized the loan activities of the Reserve Banks, were most potent factors in bringing about a better understanding with their members.

QUICK MEETING OF CURRENCY NEEDS

At the same time the ability of the Federal Reserve Banks, through their power of note issue, to supply the rapidly expanding currency needs of the country, led to free development of this function. The process by which Federal Reserve notes are issued and redeemed is perhaps worthy of a brief description here. A member bank desiring currency or coin, requests the Federal Reserve Bank to charge its account and if it finds itself with more currency than it desires to retain in vault, or has currency which is no longer fit for use, it forwards the surplus to the Federal Reserve Bank for credit. The Reserve Banks pay the cost of shipping currency or coin both ways, thus facilitating the prompt redemption of currency which is in excess of the immediate needs of the country and enabling member banks

to operate with a minimum of vault reserve. The payment of cost of shipment of currency to the member banks was developed by the Federal Reserve Banks in an effort to give member institutions outside of the Federal Reserve cities as nearly as possible similar service to that given banks in the Federal Reserve cities. A similar policy for shipments of currency received from member banks was adopted as an incident to par check collection, with the object of eliminating any element of cost to a member bank in remitting for checks sent it for collection by the Federal Reserve Bank.

Check Collection Plan Progressed Slowly

The Federal Reserve check collection, on the other hand, was long an obstacle to the development of close relations with member banks because of the opposition of many of the banks in smaller places to the change in practice which this System involved. The collection of checks through the Reserve Banks has, however, made tremendous growth, and each Federal Reserve Bank now sends daily letters containing checks for collection to practically all of the banks of its district, both member and non-member. Similar contact results from the collection of notes, drafts, bills of exchange, coupons, maturing bonds, etc., which is undertaken by the Federal Reserve Banks.

Other important facilities are transferring funds by wire between various sections of the country without charge to the member bank and the safekeeping of securities—the Federal Reserve Bank of New York alone now holding in this manner for its members $1,239,215,899 of bonds and other securities. In all the transactions between the Federal Reserve Banks and their members, the attitude of the Reserve Banks is like that of any other bank dealing with correspondents, and matters are handled along banking lines, a fact which has had much to do with the development of the close relations which now exist between Reserve Banks and their members

Better Banking Methods

An important influence has been exerted by the Federal Reserve Banks making for improvement of banking methods on the part of member banks. The practice of obtaining financial statements from borrowers has become much more general because there is the possibility that the member bank may later desire to rediscount the paper with the Federal Reserve Bank, and also because the requirement of borrowers' statements (for notes of $5,000 or over) by the Federal Reserve Banks has had the effect of standardizing this practice and leading to its adoption by banks which had formerly not considered it feasible. Membership in the Federal Reserve System has made for important changes in the character of bank investments, mainly in the direction of greater liquidity. Banks which had formerly carried bonds or call loans on stock exchange collateral as their so-called secondary reserve, have adopted the sound practice of diversifying their investments by adding to their portfolios commercial paper purchased in the open market and such highly liquid elements as bankers' acceptances and United States certificates of indebtedness. Thus they have placed themselves in much stronger position as to availability of funds to meet withdrawals by carrying adequate amounts of paper available for rediscount or sale, and, also, at least a moderate amount of paper of short maturity. This improvement in the distribution and liquidity of member banks' investment holdings has enabled them with safety

to invest their funds more closely than ever before with resulting increase in profit.

In the important matter of check collections, also, the practice of the Federal Reserve Banks of deferring credit on out-of-town checks a sufficient time to permit of their actual collection, has led to realization of the importance of promptness in the handling of out-of-town checks, and closer analysis than formerly of accounts involving the element of collection time. The direct activities of the Federal Reserve Banks in collecting checks for their members has reduced very materially, and perhaps cut in half, the time required to collect out-of-town checks, and encouragement has also been given to member banks to form county clearing houses so that banks in neighboring towns may exchange with each other and still further reduce the time required for collection of such checks.

BANKS NEED LESS CASH IN VAULT.

More economical methods as to the holding of vault cash by member banks have been made possible by improved facilities for obtaining currency and coin, and by legislation enacted in 1917, relieving member banks from the former requirement for a fixed amount of cash in vault. In October, 1914, the 7,571 national banks of the country held cash in vault equal to 16.4 per cent of their deposits. On June 30, 1921, 9,745 member banks held vault cash equal to only 2.6 per cent of their deposits.

The influence of the Federal Reserve Banks making for improvement in the technical features of bank operation, though not readily measured, has been of fundamental importance and is among the most beneficial results of the System's operations, especially when considered with full realization of the importance in modern economic organization of a banking machinery adapted to the great tasks which devolve upon it.

For obvious reasons no publicity has been given to a highly important Reserve Bank activity, the assistance of member banks which for any reason find themselves in a dangerous position; and the confidential character of this relationship precludes other than a very general statement concerning it. In a considerable number of instances the Reserve Banks have not only extended assistance in the way of loans, but have also loaned members of the Reserve Bank staff to assist the institutions through their difficulties, with the result, in a number of instances, that institutions which would otherwise have been forced to succumb, have been rehabilitated and are now in successful operation.

Close relations with member banks have also been assisted in some districts by conferences of member bankers with Federal Reserve Bank officers, at which the operations and functions of the Federal Reserve Banks were clearly and fully explained, and also by visits to member banks at their home offices, made by Reserve Bank representatives. The officers of the Federal Reserve Banks realize an obligation to extend a service of high order to member banks, and to promote coöperation along banking lines rather than to take an attitude which might lead member banks to feel that they were dealing with a distant and impersonal organization operated as a government agency. In other words, the Federal Reserve Banks have undertaken to function as *banks* and to conduct their relations with member banks along much the same lines as those by which the larger banking institutions of the country have in the past so successfully conducted their relations with out-of-town correspondents. The highly satisfactory results of this policy are to be found in

the friendly attitude which is now manifest on the part of member banks toward the Federal Reserve Banks.

INTER-RELATIONS OF RESERVE BANKS

The establishment of twelve regional Federal Reserve Banks rather than of a central bank, was in keeping with the great area of our country, which might be considered as making the establishment of one great central bank of doubtful advantage, and with the American predilection for the minimum of banking centralization. The twelve Federal Reserve Banks were to be, and are, operated each by its own board of directors, and each is to a very large degree an independent entity, having power to deal with the problems arising within its own district according to the judgment of its directors and officers. This has given opportunity for the development of a considerable degree of individuality in personnel and methods, and for the control of each Federal Reserve Bank by men familiar with the business of the district.

Counteracting to a considerable degree this tendency to individuality in the management and operations of the several Federal Reserve Banks, is the influence of common function and purpose, of interbank contact, and, also, the supervision of the Federal Reserve Board. The practically identical relationship of each Reserve Bank to its members and the similarity of functions, led early to efforts to coördinate action on all matters possible of common solution. Even before the organization of the Federal Reserve Board and the Federal Reserve Banks, the preliminary Organization Committee had prepared plans for accounting and methods which were to a considerable extent used by the Reserve Banks when organized, though modified in many ways as experience showed need for change.

A conference of governors and directors of all Federal Reserve Banks preceded the actual opening of the Banks. Problems of general policy before the Banks and the Federal Reserve Board, have been the subject of discussion at conferences held from time to time by governors and Federal Reserve agents. Numerous conferences have also been held by representatives of the Reserve Banks to deal with the more technical features of operation, such as accounting and auditing methods, check collections, employment methods and other similar problems. The spirit of coöperation and willingness to take counsel together, evidenced at these conferences, has been typical of the everyday relations between the Reserve Banks and has resulted in the development of a close-knit system in which the several units, though independent in management, work together to obtain for their members and the public the advantages to be derived from a unified banking system.

The results of coöperation among the Federal Reserve Banks are in some cases very tangible, as, notably, the country-wide check collection system, the establishment of facilities for transfers of funds over the private wires between Federal Reserve Banks, the establishment of a Gold Settlement Fund through which has been obviated the necessity of gold shipments between different parts of the country, and, perhaps most important of all, the facilities for interbank rediscounts by means of which seasonal loan demands may be met by the Reserve Banks whose positions are relatively strong and who loan to those on which the pressure is greatest. The advantage claimed for a central bank with ability to direct the flow of loanable funds to the point of maximum need, appears to have been attained through this arrangement, as interbank rediscounts have been freely

and voluntarily made in such amounts as were necessary to meet the heavy loan demands in many districts which would otherwise have found themselves with greatly impaired reserves.

The heaviest borrowers relatively have been the Federal Reserve Banks in the agricultural sections, the lenders being usually the banks in sections whose activities are predominantly industrial. The interbank loans at their high point were as shown in the table below:

INTER-BANK LOANS OF FEDERAL RESERVE BANKS

Borrowers				*Lenders*			
Bank	Amount	Reserve Before	Percentages After	Bank	Amount	Reserve Before	Percentages After
New York....	$49,305,000	35.3	38.6	Boston.........	$85,896,000	72.0	51.1
Richmond....	19,900,000	35.4	45.8	Phila...........	42,722,000	63.8	52.3
Atlanta.	37,758,000	23.2	40.5	Cleveland......	137,874,000	80.5	52.3
Chicago......	13,050,000	37.9	39.5	San Francisco...	886,000	45.2	44.9
St. Louis.....	40,410,000	21.0	41.3				
Minn.........	27,204,000	17.0	39.0				
Kansas City...	45,807,000	17.4	42.5				
Dallas.......	33,944,000	13.2	40.9				
TOTAL....	$267,378,000				$267,378,000		

action of Congress. The policy of the Reserve Board, as revealed in its rulings and the public utterances of its members, has been consistently to refrain from performing operating functions in connection with the management of the Reserve Banks and to make its field of activity the supervision and coördination of twelve practically independent regional reserve institutions. Its rulings and regulations have served to interpret and apply the law under

The chart on page 94 illustrates graphically the movements of reserves of the Federal Reserve Banks, evidencing the pressure of demand for loans which could be safely met only by rediscounting.

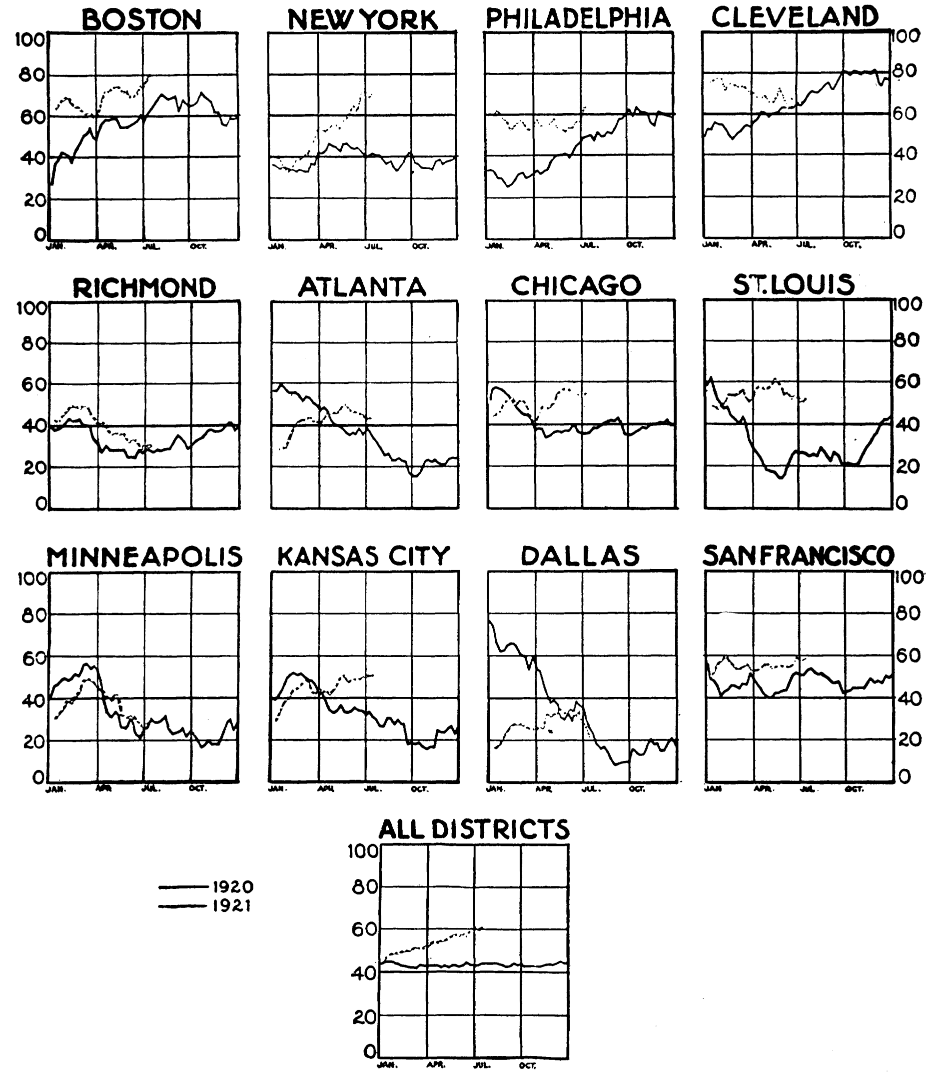
RESERVE BOARD'S INFLUENCE FOR UNITY

Strong as were the forces which have been mentioned in making for close relations and coöperation on the part of the Federal Reserve Banks, the position of the Federal Reserve Board, as the central element in the Federal Reserve organization, is one of such great influence that its policies may be regarded as in large measure responsible for the course which has been taken in the development of the System provided for in general outline by the

which the Reserve Banks operate, and also to bring about general uniformity in the policies of the Reserve Banks, while leaving a large discretion to the management of each Bank as to the acceptance or rejection of individual paper, offered for rediscount, and as to other problems of operation.

Thus there has been noted in the operations of the Federal Reserve System a combination of uniformity of policy and flexibility of everyday operation which would be difficult or perhaps impossible under a system where the operating function was controlled by a central body. A tendency toward similarity of discount rates at the several Reserve Banks has been apparent, though differences in conditions have prevented and are likely to prevent complete uniformity in this

RESERVE PERCENTAGES FEDERAL RESERVE BANKS BEFORE INTERBANK ACCOMMODATIONS



particular. Practices as to check clearing and collection, collection of notes and drafts, supplying currency and coin, and loaning operations, are much alike at the different Reserve Banks, yet each Bank may, independently within the limits set by the law and the Federal Reserve Board's ruling and regulations, perfect and improve its methods of operation at its own option.

The Federal Reserve Board has made very clear that the Federal Reserve System is not a central bank or its equivalent, but that the twelve Federal Reserve Banks are independent institutions over which the Federal Reserve Board exercises supervisory authority, without attempting to participate directly in the management.

It thus appears that the advantages

to be expected from the free flow of credit from one part of the country to the other to meet demands for commercial, industrial or agricultural purposes, are supplied by the inter-bank rediscounting feature of the Federal Reserve System, but that the aim of having the problems of each district entrusted to directors living within the district and to officers closely familiar with these problems, with full discretion and power to act within their own districts, has also been attained. The Federal Reserve System may be said to give the advantages of the mobilization and centralization of banking reserves while preserving the typically American freedom from highly centralized control.

The Evolution and Practical Operation of the Gold Settlement Fund

By GEORGE J. SEAY
Governor of the Federal Reserve Bank of Richmond

IT is difficult to realize that only seven years have elapsed since the establishment of the Federal Reserve Banks. During that period, matters of such tremendous import to the world have happened and developments in banking and finance have been so revolutionary in their nature and size that we have a full understanding of the feelings of the small boy of seven who declared that, although only seven, judging by the experience he had had, he was 'most a hundred. Since 1914, the resources of the banks of the United States have grown from 27 billions of dollars to 53 billions, and bank clearings have grown from 155 billions to 451 billions. In measuring the national debt, the income of the Treasury and taxation, the unit is no longer a million but a billion.

All the momentous and tragic experiences of life leave an impression upon the mind of having occupied a prolonged period. Therefore, it seems that the Federal Reserve System has been operating for a period much longer than that measured by seven calendar years. As a matter of fact, it has, beyond doubt, developed in those seven years at a pace far more rapid than could have been expected in normal times. The country seems accustomed and seasoned to the operations of the Federal Reserve System, but, it becomes apparent from time to time that many people and even many banks have not a full appreciation of the accomplishments of the System or a full understanding of the fact that financial transactions of the magnitude developed within these seven years were rendered possible only by the operation of the System.

The country banker, when he sends his checks and collection items to his city correspondent, may think that thereby he is creating exchange. This is but the first and the lowest step in the creation of exchange. The processes involved in the collection and final settlement of such items are numerous and they constitute the fabric of exchange. The Federal Reserve System has developed the most comprehensive and most effective system of exchange known to the banking world.

The Federal Reserve Banks act as clearing houses for their members, and the various transactions engaged in by these banks create balances between